United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL
WITH PROOF
OF SERVICE

77-6034,

77-6038, 77-6040, 77-6045, 77-6048, 77-6065

B

P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

In the Matter
of
WEIS SECURITIES, INC.,

Debtor.

GEORGE ALDRICH, et al.,

Appellants,

v.

EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION CORPORATION,

Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF NEW YORK

JOINT BRIEF FOR APPELLANTS

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SECOND CIRCUIT

LAWRENCE BLOCK
THOMAS P. LUNING
CARL A. ROYAL
SCHIFF HARDIN & WAITE
7200 Sears Tower
233 South Wacker Drive
Chicago, Illinois 60606

and

ALAN C. WINICK
500 Fifth Avenue
New York, New York 10036

Attorneys for All American Life & Casualty Co., General United Life Insurance Co. and Robert Slater

SIDNEY DICKSTEIN
DICKSTEIN, SHAPIRO & MORIN
2101 L Street, N.W.
Washington, D.C. 20037

Attorneys for George Aldrich, H. Wallace Cohu, John DeBraganca, James J. Higginson, Grace Cutting McGrath, Grace M. McGrath, Craig K. Mitchell, Eugene W. Stetson, Jr., Jean M. Winslow, Samuel Winslow, Estate of Philip D. Holden, Deceased.

WILLIAM J. SCOTT
Attorney General of Illinois
160 North LaSalle Street
Chicago, Illinois 60601

and

MILLER, SINGER, MICHAELSON,
BRICKFIELD & RAINES
555 Madison Avenue
New York, New York 10017

Attorneys for Eva Grossman

ZALKIN, RODIN & GOODMAN
750 Third Avenue
New York, New York 10017

Attorneys for Chemical Bank

BAER & MARKS
70 Pine Street
New York, New York 10005

Attorneys for Fidelity Corporation

STACKPOLE & AMIDON
P.O. Box 1016
Stowe, Vermont 05672

Attorneys for Arthur J. Kriezel

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United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket Nos.

77-6034, 77-6038, 77-6040, 77-6045, 77-6048, 77-6065

In the Matter of

WEIS SECURITIES, INC.,

Debtor.

GEORGE ALDRICH, *et al.*,

Appellants,

v.

EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION CORPORATION,

Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF NEW YORK

JOINT BRIEF FOR APPELLANTS

Preliminary Statement

The opinion and order appealed from were issued by the Honorable Inzer B. Wyatt, District Judge, on appeal from an opinion and order of the Honorable Roy Babitt, Bankruptcy Judge. Judge Wyatt's opinion and order are reported at 425 F Supp. 212, and Judge Babitt's opinion is reported at [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,666.

Statement of Issues for Review

1. Do Claimants, who as innocent victims of fraud by Weis Securities, Inc. executed agreements subordinating their loans of cash or securities to claims of other Weis creditors, have a right to rescind such agreements under the common law and the federal securities laws which may be enforced in Weis' liquidation?

2. Do the federal securities laws or the New York Stock Exchange's net capital rule deprive Claimants of their right to rescind fraudulently induced subordination agreements?

3. Are Claimants estopped from rescinding fraudulently induced subordination agreements by the provisions of the agreements, where they did not have knowledge of or participate in the fraud and in the absence of proof of reliance upon the subordination agreements by those who would benefit from the estoppel?

4. Do issues of fact preclude summary judgment against innocent victims of fraud in this case?

Statement of the Case

These are 6 appeals by 18 appellants from an opinion and order of the District Court (A406-A423) reversing an order of the Bankruptcy Court (A379-A389) which denied the motion for summary judgment of the Trustee for Weis Securities, Inc. on his objections to appellants' claims filed in the Weis liquidation proceedings.

The proceedings for the liquidation of Weis Securities, Inc., formerly Weis, Voisin & Co., Inc. ("Weis"), began on May 24, 1973. On that day a complaint (A1) was filed against Weis and certain of its officers by the Securities

and Exchange Commission ("SEC"), and an Application (A15-A20) was filed in the same case by the Securities Investor Protection Corporation ("SIPC") requesting that the court enter a decree adjudicating that Weis' customers were in need of the protection provided by the Securities Investor Protection Act of 1970, 15 U.C.C. §§78aaa—78*lll*. On May 30, 1973, Edward S. Redington was appointed Trustee to liquidate Weis. (Record Document No. 2)

Appellants are 18 claimants (hereinafter "Claimants") who, at various times prior to the filing of the Weis liquidation proceedings, had executed documents which subordinated their accounts with or loans to Weis to the claims of certain other Weis creditors. When the fraud of the Weis principals was disclosed, Claimants and other subordinated lenders rescinded the agreements which purported to subordinate their rights to repayment and filed claims against the Weis estate. (A43-A230)

The Weis Trustee took the position that, despite the fraud by Weis, persons who had signed subordination agreements should not be entitled to rescind, and he filed an "Application" with the Bankruptcy Court on April 23, 1974, asking the Court to confirm his position. (Record Document No. 26) The Application was granted by default as to those parties who did not object, and it was withdrawn or denied as to those who did object. (Record Document No. 48)

The Trustee subsequently filed objections to the claims of the remaining allegedly subordinated lenders (A231-A259), and he sought summary judgment on his objections and an order that each such claim be allowed only on a subordinated basis. (A260-A305) Bankruptcy Judge Babitt denied the Trustee's motion on July 16, 1976, in what the District Judge later called a "thoughtful" opinion. (425 F.Supp. at 213; A408) He held that a subordination agreement induced by fraudulent misrepresentation may be rescinded. (A383) He further held that although reliance

by a senior creditor on the subordination agreement would raise an estoppel barring rescission, whether such reliance in fact occurred was a question of fact which precluded summary judgment. (A383) Bankruptcy Judge Babitt rejected the Trustee's argument that the existence of the net capital rule of the New York Stock Exchange, Inc. ("NYSE") was a substitute for proof of reliance upon the subordination agreements, and he found it improper to presume reliance as a matter of law. (A385) In response to the Trustee's argument that the allegedly subordinated lenders had made enforceable subordination contracts with the NYSE, the Court observed that there was no evidence that such contracts existed.* (A386) Accordingly, the Bankruptcy Judge denied the Trustee's motion for summary judgment, holding that there were material issues of fact concerning whether general creditors relied on the subordination agreements or the net capital rule when they invested in or extended credit to Weis, and whether the subordinated lenders entered into separate subordination agreements with the NYSE. (A386-A387)

The Trustee and SIPC appealed to the District Court from the Bankruptcy Court's decision. (Record Document Nos. 84 and 85) Motions to dismiss the appeals were filed by certain Claimants on the ground that no appeal should be allowed from an interlocutory order denying a motion for summary judgment, but the District Court denied the motions. (A390-A397; Record Documents Nos. 87-90) On January 20, 1977, District Judge Wyatt filed an opinion and order reversing the order of the Bankruptcy Court and remanding the matter to the Bankruptcy Judge for further proceedings consistent with Judge Wyatt's opinion. (425 F.Supp. 212; A406-A423) Judge Wyatt dis-

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* The District Court did not consider this issue and therefore it is not presented for review on these appeals.

missed as "dicta" the holding of this Court in *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966), and held:

> There is not only no controlling authority on the point here at issue; there are no decisions on the point. We must consider, therefore, what equity and fairness would suggest. This seems clearly to be that, as between the customer and other general creditors of Weis on the one hand (for whom the trustee speaks) and the subordinated lenders on the other, the agreements of the latter should be enforced according to their terms in distributing the assets of Weis. As between Weis and the subordinated lenders, the latter are entitled to rescind if fraud is proved; the trustee recognizes this. If the subordinated lenders prove fraud, their claims should be paid before anything is distributed to the stockholders of Weis. But the customer and other general creditors of Weis should be paid before anything is paid to the subordinated lenders. Every customer and general creditor of Weis knew, or is presumed to have known, that the broker-dealer business of Weis was regulated by federal law and that as part of such regulation the net capital rule was enforced. The subordinated lenders, by their agreements, enabled Weis to comply with the net capital rule and thus to continue in business. The customer and general creditors of Weis should therefore have priority. Under the circumstances, actual reliance is not required to be shown. If the reliance doctrine must be satisfied as a point of dogma, it should be presumed as a matter of law. 425 F.Supp. 216-17; A418-A419.

Claimants appealed to this Court from Judge Wyatt's decision. (Record Document Nos. 92, 93, 95-99) Pursuant to the Civil Appeal Preargument Conference Order entered in these appeals on March 16, 1977, this joint brief is submitted on behalf of all appellants and deals with

issues common to all appellants. Supplementary briefs are being filed on behalf of certain appellants to deal with issues affecting only those appellants. In addition the Weis, Voisin & Co. Employees' Profit Sharing Plan and Trust is filing a separate brief in its own appeal (No. 77-6044) from the same opinion and order.

Statement of Facts

The Subordination Agreements and the Fraud

Weis had been a prominent registered broker-dealer and a member of NYSE. (425 F.Supp. at 213; A408) Its certified financial statements showed healthy earnings and a substantial net worth. (A281-A292) Like many registered broker-dealers supervised by NYSE, Weis borrowed money and securities pursuant to agreements which subordinated the lenders' claims to claims of senior creditors. (A268-A269) The cash and securities obtained pursuant to the subordination agreements were then available for unrestricted use in Weis' business. (A295-A302)

Claimants all executed subordination agreements with Weis. (A43-A230) Nine of the Claimants* loaned or collateralized loans totaling $6,745,000, and the other nine Claimants** loaned cash and securities in their accounts with Weis. (A273-A278)

In fact, Weis' financial statements did not accurately reflect Weis' financial condition. Certain principal officers of Weis had falsified its books and records, to the extent of overstating the current earnings and net worth shown

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* George Aldrich, Samuel Winslow, Eva Grossman, Chemical Bank (successor to Security National Bank), All American Life & Casualty Company, General United Life Insurance Company, Robert E. Slater, Fidelity Corporation, Arthur Kriezel.

** H. Wallace Cohu, John DeBraganca, James J. Higginson, Grace Cutting McGrath, Grace M. McGrath, Craig K. Mitchell, Eugene W. Stetson, Jr., Jean M. Winslow, Estate of Philip D. Holden, Deceased.

in Weis' May 26, 1972 financial statements by at least $2,000,000. (A21-A42) Despite these gross misstatements, Weis' independent auditor, Touche Ross & Co., certified the May 26, 1972 financial statements without any qualifications in its opinions. (A281-A292) The extent of the fraud was described for the first time for the public and for Claimants in the affidavit of Jeffrey S. Morrison, a senior examiner of the SEC's New York Regional Office, filed in this case on May 24, 1973. (A21-A42) Subsequently, injunctions were entered without contest against Weis and its officers on the SEC's Complaint filed in this case. (A3-A5) In addition, five of Weis' principal officers were indicted, convicted (four on guilty pleas) and sentenced on various charges of criminal violations of the securities laws. *United States* v. *Arthur Levine, et al.*, No. 73 Crim. 693, in the United States District Court for the Southern District of New York.

Claimants, who relied upon Weis' financial statements, were therefore defrauded and induced to enter into the subordination agreements by fraudulent misrepresentations. The Trustee conceded the fraud for purposes of this summary judgment motion in the courts below (A270-A271), and these appeals start from the premise that Claimants were fraudulently induced to enter into the agreements in question.

The Net Capital Rule

Weis was able to use the cash and securities obtained from Claimants for various business purposes. In addition, for financial statement purposes, it was allowed by NYSE rule to treat amounts received on a subordinated basis as capital in order to satisfy the NYSE's net capital rule. (A295-A302)

The NYSE net capital rule prohibited a NYSE member from allowing its "aggregate indebtedness" to exceed its "net capital" by more than a ratio of 15 to 1. "Ag-

gregate indebtedness" consisted of the firm's liabilities (with certain exclusions), and its "net capital" was basically its net worth (with certain exclusions). In testing its compliance with the net capital rule, a NYSE member firm was permitted to include cash and securities it had obtained pursuant to subordination agreements in the capital portion of the ratio, rather than in the indebtedness portion. (A295-A302)

Weis' financial statements show that it, like other brokerage firms, relied upon its ability to attract subordinated cash and securities for its net capital. Weis' February 23, 1973 financial statement reported that its subordinated liabilities were slightly over $19 million, while its stockholders' equity was only $7 million. (A294-A294A) As of May 26, 1972, the date of the last independent audit of Weis' financial statements, Weis' subordinated liabilities were almost $15 million and its stockholders' equity was approximately $7.6 million. (A281-A292)*

SIPC and This Litigation

The liquidation proceeding below is being conducted under the Securities Investor Protection Act of 1970 ("SIPA"), 15 U.S.C. §§78aaa-78*lll*. SIPA was enacted as an amendment to the Securities Exchange Act of 1934, see 15 U.S.C. §78bbb, in the wake of failures of a number of brokerage houses in the months and years preceding its enactment. Its express purpose was "to provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles." H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. (1970), *reprinted in* [1970] U.S. Code Cong. & Ad. News 5254, 5255. The Act provided for the creation of SIPC and requires brokerage houses to become members of SIPC, 15 U.S.C. §78ccc(a), and to contribute to the SIPC fund, 15 U.S.C. §78ddd.

* It was subsequently discovered that the stockholders' equity figures in the statements were grossly overstated. (See Affidavit of Jeffrey S. Morrison, A21-A42.)

The SIPC fund is used to make prompt payment of customer claims up to specified amounts against a brokerage house in liquidation under the Act, 15 U.S.C. §78fff(f). SIPC is then subrogated to the claims of customers. *Id.*

In the Weis liquidation, SIPC is by far the largest creditor of the general estate because of its subrogation rights. Customers of Weis have been paid from the SIPC fund to the limits specified in the Act.

Since SIPC is the largest creditor of Weis' general estate, it and the brokerage firms which comprise its membership would be the primary beneficiaries of affirmance of the District Court's order on appeal. A reversal of the District Court's order would allow trial of facts which could lead to Claimants' sharing in Weis' general estate with other general creditors including SIPC, or, in the case of certain Claimants,* permit trial of facts which could lead to treatment as Weis customers.

ARGUMENT

Summary of Argument

Elementary principles of common law and fundamental policies of the federal securities laws protect Claimants' right to rescind agreements which were obtained by Weis' fraudulent misrepresentations. No provision of SIPA and no special rule for liquidation proceedings deprives Claimants of this basic right to rescind for fraud. Withholding the right to rescind would be contrary to significant policies of the common law and of the securities laws.

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* George Aldrich, H. Wallace Cohu, John DeBraganca, James J. Higginson, Grace Cutting McGrath, Grace M. McGrath, Craig K. Mitchell, Eugene W. Stetson, Jr., Jean M. Winslow, Samuel Winslow and the Estate of Philip D. Holden, Deceased, assert that after rescinding they should be allowed to make customer claims against the Weis estate (A43-A101, A108-A141, A152-A162). Their claims for customer treatment are not in issue on these appeals.

In their effort to find an exception to the general rule that innocent victims of fraud are entitled to rescind, the Trustee and SIPC have asserted that Claimants are estopped from rescinding as against other creditors of Weis by the federal securities laws and the NYSE net capital rule. But there is nothing in the federal securities laws which purports to limit a defrauded subordinated lender's right to rescind, and the District Court erred in concluding that the NYSE net capital rule and related laws affected the right of Claimants to rescind for fraud.

No provision of the net capital rule itself and nothing in its purpose, which is to support brokers' liquidity, requires limitation of the right to rescind. The exercise of rescission rights in cases of fraud would not interfere with the effectiveness of the rule in its normal operation. Requiring enforcement of subordination provisions despite their fraudulent inducement would lessen the availability of subordinated loans and would thus have a serious adverse impact upon the brokerage industry.

The claim that Weis' creditors relied upon the net capital rule is unproven speculation, and it is far more likely that, if they relied upon anything at all, they relied upon the same Weis financial statements on which Claimants relied, upon adequate supervision of Weis by the SEC and by the NYSE, and upon the insurance protection provided by SIPA. The loss from Weis' fraudulent activities should be borne by SIPC and the brokerage industry which makes up its membership, not by innocent victims of fraud.

Basic requirements for application of estoppel are not present in this case. Insofar as the Trustee and SIPC argue that Claimants were estopped from rescinding by the language of the subordination agreements, their argument is expressly rejected by specific provisions of the federal securities laws. Under traditional principles of the law of estoppel, a party may not be estopped from rescinding for fraud in the absence of proof that he participated in the fraud or had knowledge of facts constituting the

fraud, or in the absence of proof that the persons who would benefit from the estoppel relied upon the fraudulently induced agreements and the benefits thereof. It is conceded that Claimants did not participate in Weis' fraud and had no knowledge of it. There was no proof of reliance by Weis' creditors on the subordination agreements or the availability of Claimants' cash and securities, and there is no authority and no justification for presuming such reliance.

Finally, there are numerous questions of fact which must be resolved even if the estoppel theory advanced by the Trustee and SIPC were to be accepted. Therefore, summary judgment is improper in this case.

I.

Claimants Were Entitled To Rescind Agreements Obtained by Weis' Fraudulent Misrepresentations.

The Trustee conceded, for purposes of his summary judgment motion, that Claimants were the victims of Weis' fraud and that the subordination agreements in issue were fraudulently induced (A270-A271). In view of those admitted facts, Claimants had a clear right to rescind the agreements under the common law and under the federal securities laws, and their right to rescind survived the filing of liquidation proceedings against Weis.

A Common Law Principles Establish and Protect Claimants' Right To Rescind.

At common law, a contract induced by misrepresentations may be rescinded by the innocent party. *E.g., Fredonia Broadcasting Corp., Inc.* v. *RCA Corp.*, 481 F.2d 781, 790 (5th Cir. 1973); *duPont* v. *Perot*, 59 F.R.D. 404, 410 (S.D.N.Y. 1973); *Channel Master Corp.* v. *Aluminium Limited Sales, Inc.*, 4 N.Y.2d 403, 176 N.Y.S.2d 259, 262, 151 N.E.2d 833 (1958); 12 *Williston on Contracts* §1523 (3d ed.

1970). The policy underlying the right to rescission in the case of misrepresentation is so strong that rescission is permissible even in the event of mere negligent misrepresentations or omissions. *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 n. 21 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969), *cert. denied,* 404 U.S. 1005 (1971). Here, where the misrepresentations were concededly deliberate, the policy in favor of rescission is strongest.

B. The Federal Securities Laws Establish and Protect Claimants' Right To Rescind.

The Trustee and SIPC have not denied, as indeed they could not, that the subordination agreements in question on these appeals are securities within the meaning of the federal securities laws. The term "security" is broadly defined by Section 2(1) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §77b(1), and by Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78c(a)(10), to include, *inter alia,* any "note", "evidence of indebtedness", or "investment contract". This Court has recently considered a subordination agreement made with Weis and concluded that subordinated notes issued by Weis were "securities." *Exchange National Bank of Chicago* v. *Touche Ross & Co.,* 544 F.2d 1126 (2d Cir. 1976). Other courts and the SEC have similarly concluded that subordination agreements are securities. *New York Stock Exchange, Inc.* v. *Sloan,* 394 F.Supp. 1303, 1311 (S.D.N.Y. 1975); *Aixala* v. *W. E. Hutton & Co.,* [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,981 (S.D.N.Y. 1975); *Hughes* v. *Dempsey-Tegeler & Co., Inc.,* [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,133 (C.D. Cal. 1973), *aff'd on other grounds,* 534 F.2d 156 (9th Cir.), *cert. denied,* 97 Sup.Ct. 259 (1976); Securities Act Release No. 5215, Exchange Act Release No. 9412, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,455 (1971).

Since the subordination agreements are securities within the meaning of the federal securities laws, Claimants are protected by the antifraud provisions of those laws, including Sections 12(2) and 17(a) of the Securities Act, 15 U.S.C. §§77*l*(2), 77q(a), and Sections 10(b) and 15(c)(1) of the Exchange Act, 15 U.S.C. §§78j(b), 78*o*(c)(1). The fraudulent representations made by Weis, including the false certified financial statements upon which Claimants relied, violated these antifraud provisions, as the Trustee and SIPC have conceded for purposes of the Trustee's summary judgment motion. Therefore Claimants are entitled to exercise the remedies provided by law for victims of such violations.

A primary remedy under the securities laws for a victim of fraud is rescission. The right of rescission is clearly established in Section 12 of the Securities Act, 15 U.S.C. §77*l*, and in Section 29(b) of the Exchange Act, 15 U.S.C. §78cc(b), and both acts state that rights and remedies provided by the statute "shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. §§77p, 78bb. The courts have universally affirmed and carefully guarded the right of innocent victims of securities fraud to rescind and recover the consideration they furnished or rescissional damages. *E.g., Gordon* v. *Burr*, 506 F.2d 1080, 1083-85 (2d Cir. 1974); *Myzel* v. *Fields*, 386 F.2d 718, 740-49 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

The Supreme Court of the United States recognized the significance of the right to rescind and the importance of preserving that right in order to serve the policies of the securities laws in *Deckert* v. *Independence Shares Corp.*, 311 U.S. 282 (1940). In *Deckert*, the Court upheld the right to rescind of defrauded purchasers seeking relief under the Securities Act. The Court held that the Securities Act "indicates an intention to establish a statutory right which the litigant may enforce by such legal or equitable actions or procedures as would normally be avail-

able to him," 311 U.S. at 287-88, and in elaboration of that holding, the Court stated:

> The power to *enforce* implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant, according to the exigencies of the particular case. 311 U.S. at 288. (Emphasis in original.)

The "exigencies of the particular case" here require that Claimants' right to rescind be preserved. No other effective recovery is available to them.

In cases subsequent to *Deckert*, the Supreme Court has continued to recognize and emphasize the importance of an effective private right of action for violation of the antifraud provisions of the federal securities laws. In *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433 (1964), an action brought under the Exchange Act, the Supreme Court stated that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the Congressional purpose" and "to adjust the remedies so as to grant the necessary relief where federally secured rights are invaded." See also *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971).

The statutes, the cases and the policies underlying them mandate the preservation of the right of these innocent victims of fraud to rescind.

C. The Right To Rescind for Fraud Is Preserved in Liquidation.

The importance of the right to rescind a fraudulently induced agreement is such that the right persists even when the defrauding party is insolvent and in liquidation.

The right exists even though the insolvent party is in a regulated industry, and even though rescission by the victim will mean that other, ordinarily senior, creditors will receive less in liquidation.

The Supreme Court considered these precise issues in *Oppenheimer* v. *Harriman National Bank & Trust Co.*, 301 U.S. 206 (1937). In *Oppenheimer*, the plaintiff shareholder was induced to purchase bank stock in 1930 by fraudulent misrepresentations made by the bank's officers. The bank closed in March of 1933 since it was unable to meet current demands, and a conservator was appointed in accordance with federal statute. Plaintiff then sued to rescind his purchase on the ground that it had been induced by fraud. The district court ruled against plaintiff after finding that the bank was not enriched by the sale. This Court held that the stockholder's rescission claim was valid, but that his judgment would be paid only out of assets remaining after satisfaction of general creditors. A *unanimous* Supreme Court reversed, holding that the rescinding stockholder stood "on the same footing as other creditors" and that his fraud claim was "entitled to rank on a parity with other unsecured creditors' claims." 301 U.S. at 215.

The sequence of events in *Oppenheimer* is significant and analogous to the factual situations in this case. The defrauded purchaser of bank stock brought his action to rescind after holding the stock for a period of three years, during which time he received dividends on the stock. The Supreme Court held that these facts did not bar his right to rescind. 301 U.S. at 213-14. The rescission action was brought nearly three months *after* the insolvent bank closed and more than two months *after* a conservator was appointed in accordance with federal statute, but the Court found this lapse of time to be no bar to rescission. *Id.*

Although *Oppenheimer* is the only Supreme Court decision on the point, numerous decisions of other federal courts, both before and after *Oppenheimer*, have applied

the rule stated in that case: a defrauded investor is entitled to share with the general creditors of an insolvent company's estate and is not relegated to a subordinated status. *In re Four Seasons Nursing Centers of America, Inc.*, 472 F.2d 747, 749-50 (10th Cir. 1973); *SEC* v. *Insurance Investors Trust Co.*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,259 (W.D.Ky. 1971); *In re Los Angeles Land and Investments, Ltd.*, 282 F.Supp. 448, 452 (D. Hawaii 1968), *aff'd per curiam*, 447 F.2d 1366 (9th Cir. 1971); *Clark* v. *Boston-Continental National Bank*, 84 F.2d 605, 607 (1st Cir. 1936); *Williams* v. *Green*, 23 F.2d 796 (4th Cir. 1928); *Salter* v. *Williams*, 244 F. 126, 129 (3d Cir. 1917), *appeal dismissed*, 250 U.S. 653 (1919); *Florida Land & Imp. Co.* v. *Merrill*, 52 F. 77, 80-81 (5th Cir. 1892).

Accepted principles of bankruptcy law also support the right to rescind. In bankruptcy, a party induced to enter into a contract by misrepresentation has the right to rescind even after the filing of bankruptcy proceedings and to reclaim property fraudulently obtained by the bankrupt. See generally 4A *Collier on Bankruptcy* §70.41 (14th ed. 1976). In the case of *In re Rhine*, 241 F.Supp. 86, *rehearing denied*, 242 F.Supp. 127 (D. Colo. 1965), the court upheld the right of defrauded purchasers of securities to rescind and to reclaim funds used to make their purchases which could be traced to specific bank accounts of the bankrupt issuer. The practical effect of such a holding is to allow the securities holders *priority* over general creditors. *A fortiori*, Claimants must be entitled to rescind here.

The decision of the District Court on appeal here declined to follow the holding in *Oppenheimer* and concentrated instead on the fact that the *Oppenheimer* case also involved a statutory assessment against the plaintiff shareholder as required by the National Banking Act then in force.* (425 F.Supp. at 217-18; A420-A421) Yet the plain

* That aspect of *Oppenheimer* is discussed in Section II. B. below.

holding of the Supreme Court in *Oppenheimer* was that a defrauded securities holder could rescind and share equally with general creditors in the insolvent corporation's general estate. Even commentators who disagree with that holding on policy grounds nevertheless recognize that it is the law of the land. See Slain and Kripke, "The Interface between Securities Regulation and Bankruptcy —Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors," 48 *N.Y.U.L. Rev.* 261, 268-72 (1973); Huff, "The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5," 50 *Am. Bankr. L.J.* 197, 210 (1976).

Recent legislative developments confirm that the *Oppenheimer* rule continues to be accepted law. In 1973, the Commission on the Bankruptcy Laws of the United States recommended a sweeping revision of the bankruptcy laws. Section 4-406(a) of the Commission's proposed revision would subordinate in payment to other claims "any claim for rescission of the purchase of securities issued by the debtor corporation or for damages resulting from the purchase or sale of such securities. . . ." Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, 93rd Cong., 1st Sess., Part I at 22-23, Part II at 115-16 (1973). Bills containing this provision were introduced in the last two Congresses. H.R. 10792 and S. 2565, 93rd Cong., 1st Sess. (1973); H.R. 31, H.R. 32, S. 235, S. 236, 94th Cong., 1st Sess. (1975).

Extensive hearings on these bills were held in both the House and Senate in the 94th Congress, and it was recognized by witnesses at the hearings that proposed Section 4-406(a) would change the *Oppenheimer* rule. See *Bankruptcy Act Revision, Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary,* 94th Cong., 1st & 2nd Sess. 1882, 1890 (statement of Harvey R. Miller on behalf of National Bankruptcy Conference), 2155, 2160, 2163, 2184-86, 2213 (statement and testimony of Philip A.

Loomis, Jr., and recommendations and report of SEC) (1975-1976) (*"House Hearings"*); *The Bankruptcy Reform Act, Hearings on S. 235 and S. 236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary,* 94th Cong., 1st Sess. 15 (statement of Commission on the Bankruptcy Laws of the United States), 710, 717, 726-27, 733-34, 736, 758-60 (statement and testimony of Philip A. Loomis, Jr. and recommendations and report of SEC) (1975) (*"Senate Hearings"*).

The SEC took a strong position against proposed Section 4-406(a) and in favor of retaining the right to rescind of defrauded shareholders and subordinated debtholders. *House Hearings* at 2184-86; *Senate Hearings* at 758-60. Its argument is directly applicable to this case. The SEC pointed out that *Oppenheimer* and general principles of securities law and common law give defrauded investors the right to rescind and that a defrauded investor suffers as real a loss as any other contract or tort claimant. The SEC stated that the "investor expectation" argument—that an investor takes the risk of insolvency in return for the hope of appreciation in the value of his investment—is not applicable when the investor was not in possession of all material information about the enterprise in which he invested. In cases of fraud the investor has been deprived of that information. While the investor might be said to accept some risk, "he certainly does not bargain to be defrauded." *House Hearings* at 2136; *Senate Hearings* at 760. In summary, the SEC forcefully argued that the rescinding investor and all other defrauded parties should be on a parity. The latest proposed bankruptcy law revision has eliminated Section 4-406(a). H.R. 6, 95th Cong., 1st Sess. (1977).

The SEC has taken the same position in support of the right of defrauded investors to rescind in various corporate reorganizations. SEC Corporate Reorganization Release No. 310 at 41 n. 32 (1972) (Four Seasons Nursing Centers

of America, Inc.); SEC Corporate Reorganization Release No. 226 at 13-15 (1965) (TMT Trailer Ferry, Inc.).

As discussed in Section II.C. below, the fact that the Weis liquidation is being conducted under the provisions of SIPA does not alter the established principle that defrauded investors may rescind and share in the estate of an insolvent company without being subordinated to other creditors. SIPA liquidations are to be conducted generally in accordance with the provisions of Chapter X of the Bankruptcy Act, 15 U.S.C. §78fff(c), and SIPA is to be treated as an amendment to the Exchange Act, 15 U.S.C. §78bbb. The bankruptcy and securities laws expressly recognize the right to rescind, and no provision of SIPA purports to deprive investors in or lenders to a broker of their right to rescind for fraud.

SIPC recently attempted to have SIPA amended to bar a subordinated lender from assuming customer status after rescinding. H.R. 8064 and S. 1231, 94th Cong., 1st Sess. (1975); see *Securities Investor Protection Act Amendments of 1975, Hearings on H.R. 8064 Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 1st Sess. 51-100 (1975) (statement of Hugh F. Owens). Such an amendment would be unnecessary if the law presently barred subordinated lenders from rescinding. Indeed, as pointed out by the Director of the SEC's Division of Market Regulation, even if the proposed amendment to SIPA were adopted it would "not deny the subordinated lender the right to attempt to rescind." *Id.* at 183 (testimony of Lee F. Pickard).

Contrary to the holding of the District Court below, accepted principles of federal securities and bankruptcy law clearly provide that the right of Claimants to rescind is preserved even though Weis is in liquidation.

II.

Federal Regulation of the Securities Industry and the NYSE Net Capital Rule Are Not Grounds for Depriving Claimants of Their Rights To Rescind.

The District Court did not discuss a defrauded party's right to rescind or the importance of the policies underlying that right. Instead, the Court discussed the role the NYSE net capital rule plays in federal regulation of the securities industry, finding that "equity and fairness" suggested that Claimants should be deprived of the right to rescind as against customers and other general creditors of Weis. 425 F.Supp. at 217; A418. The Court's conclusion was based upon the argument that Claimants' subordination agreements enabled Weis to comply with the net capital rule and to continue in business, that customers and creditors of Weis relied upon federal regulation of Weis and enforcement of the net capital rule, and that therefore the subordination agreements must be enforced. *Id.* The Court also drew an analogy to the bank assessment cases under the National Banking Act, which it saw as supporting the argument. 425 F.Supp. at 217-18; A419-A422.

It is not clear whether the District Court saw the net capital rule as a link in a chain of reliance by customers and creditors of Weis, or whether it thought that enforcement of the net capital rule in the statutory scheme required that subordination agreements which Weis used to comply with the rule be enforced regardless of fraud. In either event, the District Court erred.

The District Court erred in its view of the role of the NYSE net capital rule, in its attempt to analogize the National Banking Act cases, and in failing to recognize that SIPA and SIPC serve the function the District Court would have the net capital rule perform. There is no justi-

fication and no support for overriding the strong and clear policies of the securities laws, as well as of the common law, which support Claimants' right to rescind. Moreover, the District Court erred in presuming the existence of facts without a trial which were disputed by Claimants. (See Section IV, below.)

A. The Net Capital Rule and Its Role in Regulation of the Securities Industry Do Not Bar Rescission.

(1) *What the Net Capital Rule Provided and Did Not Provide*

Original Section 8(b) of the Exchange Act,* ch. 404, §8, 48 Stat. 888, prevented a member of a national securities exchange from having an "aggregate indebtedness" greater than 20 times its "net capital." In addition, the SEC prescribed a net capital rule under former Section 15(c)(3) of the Exchange Act, added by the Maloney Act, ch. 677, §2, 52 Stat. 1075 (1938). However, the net capital rule applicable to Weis was former NYSE Rule 325,** since it was considered more comprehensive than the SEC rule. Securities Exchange Act of 1934 Release No. 3617 (Nov. 8, 1944). The NYSE was charged with enforcing its net capital rule.

The NYSE net capital rule was a rule binding upon Weis, and it directed what Weis could and could not do to satisfy its requirements. It required that Weis' aggregate indebtedness not exceed 15 times its net capital. Weis was allowed, under NYSE Rule 325(b)(2)(E), though not

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* The Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 104 (1975), repealed original Section 8(b) and instead gave the SEC more general power to prescribe financial responsibility rules for brokers and dealers in amended Section 15(c)(3) of the Exchange Act, 15 U.S.C. §78o(c)(3)

** NYSE Rule 325 was amended in January 1976. The former rule was published in the New York Stock Exchange Guide (CCH) ¶2325 (1973). References in this brief to the NYSE net capital rule are to the rule as it existed in 1973.

required, to treat an approved subordinated obligation as part of its net capital rather than as part of its aggregate indebtedness. Weis did in fact treat the cash and securities it had fraudulently obtained from Claimants as part of its net capital.

It is equally important in this case to note what the net capital rule did *not* provide. Unlike the National Banking Act assessment provisions (see Section II. B. below) it did not purport to impose obligations on investors in or lenders to Weis. No provision of the net capital rule suggested that it superseded the rest of the securities laws or that the antifraud provisions of the securities laws were suspended for subordinated lenders. There was no intimation in the net capital rule that a subordinated lender to a broker assumed the risk of fraud by the broker.

Moreover, the SEC has recognized that the securities laws, including their antifraud provisions, apply to subordination agreements obtained for the purpose of complying with the net capital rule. In a 1971 release relating specifically to subordinated accounts, the SEC stated:

> The Commission cautions broker-dealers that the solicitation of account subordinations may also result in violations of the antifraud provisions of the Securities Act and the Exchange Act, and of the regulations thereunder. . . . The anti-fraud provisions apply to all activities and all literature and other statements and representations made in connection with the solicitation of subordination agreements, whether or not an exemption from registration exists under the Securities Act. Securities Act of 1933 Release No. 5215, Securities Exchange Act of 1934 Release No. 9412, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,455 (1971).

As discussed above in Section I. B., application of the antifraud provisions of the securities laws necessarily implies

the availability of an effective remedy—rescission—for their violation.

Contrary to the dire predictions of the Trustee and SIPC, the effectiveness of the net capital rule in assuring the financial responsibility of broker-dealers will not be eviscerated if Claimants are allowed to exercise their right to rescind for fraud. Claimants do not contend that subordination agreements are not ordinarily enforceable in liquidations, nor that reliance must always be shown in order to enforce subordination agreements in liquidations. Claimants merely assert that in a case in which their subordination agreements have been obtained through fraudulent misrepresentations, they are entitled to exercise their right to rescind as guaranteed by the common law and federal securities law.

(2) *Purpose of the Net Capital Rule*

The purpose of the net capital rule similarly does not lead to the conclusion that a subordinated lender should be deprived of the right to rescind for fraud. That purpose has always been to maintain brokers' liquidity, to enable them to meet current customer demands. Thomas G. Corcoran, one of the draftsmen of the Exchange Act, stated that the purpose of the net capital provision in the statute was to insure that broker-dealers have sufficient liquid assets on hand to meet current customer demands:

> A broker always needs a certain amount of immediate resources to take care of current customers' credit balances and other demands and he always owes customers some securities. *Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 87 (1934).

This statement of purpose was later echoed in the SEC's Study of Unsafe and Unsound Practices:

> [T]he purpose of net capital requirements is to have the broker-dealer maintain a highly liquid position in order to meet all of his current obligations. H.R. Doc. No. 92-213, 92d Cong., 1st Sess. 11 (1971), [Special Studies Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶74,801 at p. 65,523 (1971).

Similarly, according to then SEC Chairman Hamer H. Budge, "The primary emphasis [of the net capital rule] has always been on 'liquidity', that is, requiring a broker-dealer to have sufficient liquid assets to cover his indebtedness and a cushion of liquid assets over and above that amount." H. Budge, "Broker-Dealer Financial Responsibility Requirements," 7 *Idaho L. Rev.* 151, 158 (1970).

The net capital rule is thus viewed as an operational requirement that a broker-dealer must meet throughout the course of its business. Report of Special Study of Securities Markets of the SEC, H.R. Doc. No. 95, 88th Cong., 1st Sess., Part 1, Ch. II, p. 86 (1963). Claimants' subordinated loans and accounts fulfilled this requirement. They served as part of Weis' net capital while Weis continued to operate as a broker-dealer, providing Weis with liquidity to meet customer demands. However, now that Weis has ceased operating as a broker-dealer and no longer incurs new customer obligations, the liquidity function of the net capital rule has become irrelevant. The issue now is to determine which claimants are to share in the liquidation of Weis' assets, an issue to which the net capital rule does not purport to speak.

There is, therefore, nothing in the purpose of the net capital rule or in its role in the federal regulatory scheme for the brokerage industry which requires making an exception to accepted principles of law allowing these Claimants to rescind.

(3) *Impact on Brokerage Industry from Elimination of Subordinated Lenders' Right to Rescind for Fraud.*

The net capital rule and the policies which it implements would be ill-served by depriving subordinated lenders of their right to rescind fraudulently induced subordination agreements. Broker-dealers depend upon their ability to obtain subordinated loans and accounts for substantial amounts of their operating capital. The SEC's annual reports to Congress show that for the period from 1969 to 1974, broker-dealers with gross securities incomes over $20,000 per year had outstanding subordinated borrowings and accounts amounting to more than $1 billion each year. [1975] SEC Ann. Rep. 178; [1974] SEC Ann. Rep. 146.

One of the criticisms of the brokerage industry voiced in the SEC's 1971 Study of Unsafe and Unsound Practices was that the capital of brokerage firms was "inadequate and not sufficiently permanent or liquid." [Special Studies Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶74,801 at 65,503 (1971). The task force which made the study noted that one method of improving the capital position of brokers was for brokers to obtain more long-term bank loans. The task force observed that before making such loans, banks had to "satisfy themselves as to the security of term loans to brokerage firms." *Id.* at 65,504.

The District Court's decision would tend to discourage banks and other lenders from making long-term loans to broker-dealers on a subordinated basis. Banks and other long-term lenders recognize that in making loans to broker-dealers they must take into account the usual business risks of mismanagement and adverse market or economic conditions. If they were to be advised that in making loans to brokerage houses they also must assume the risk of recovering nothing in case the loan is procured by the broker's fraud and the broker subsequently becomes insolvent, they would avoid making such loans. Just as effec-

tive remedies for fraud support investor confidence in the securities markets, so also would the elimination of the most effective remedy—rescission—discourage lenders from making subordinated loans to broker-dealers. The interpretation of the net capital rule accepted by the District Court would thus have the effect of reducing the liquidity of broker-dealers, the exact opposite of the stated purpose of the rule.

(4) *The Invalidity of the Trustee's and SIPC's Net Capital Rule Reliance Argument*

Attempting to avoid having to show action by individual Weis customers and creditors in direct reliance upon Claimants' subordination agreements, the Trustee and SIPC have constructed an elaborate argument that such reliance should be presumed because of the role played by the net capital rule in the regulation of broker-dealers. The argument, which the District Court adverted to but did not clearly adopt in full, 425 F.Supp. at 217; A418, is an apparent effort to bring this case within the rule that advances by a senior creditor in reliance upon a subordination agreement may estop the subordinated creditor from rescinding. (See Section III.C. below.) This argument must fail because its logic is faulty and its premises are not proven.

The steps of the argument are as follows: (1) The federal securities laws provide a regulatory scheme intended to, *inter alia*, assure the financial responsibility of broker-dealers; (2) Weis' customers and creditors in dealing with Weis relied upon the safeguards provided by the federal regulatory scheme; (3) one aspect of that regulatory scheme upon which Weis' customers and creditors relied is the net capital rule; (4) the NYSE was responsible for enforcing Weis' compliance with the net capital rule; (5) the NYSE relied upon the existence of Claimants' subordinated loans to satisfy itself that Weis was in compliance and therefore allowed Weis to continue operating; (6)

Claimants made their loans to allow Weis to comply with the net capital rule, knowing that other customers and other creditors of Weis would rely on the existence of such loans; (7) reliance by other customers and creditors of Weis on the existence of Claimants' loans should thus be presumed; and (8) therefore Claimants should be estopped from rescinding.*

The first problem with this argument is that several of its premises are not proven. There was no evidence before the Bankruptcy Court or the District Court to establish steps 2, 3 or 6 of the argument, and those contentions were disputed by Claimants below. (A310-375) Summary judgment was therefore improper on that ground alone. (See Section IV below.)

The deficiencies in the argument's logic are equally serious. Too many assumptions are required to construct the links in the proposed chain from alleged generalized reliance upon the regulatory scheme to presumed reliance on Claimants' subordination agreements. For example, even assuming reliance by Weis' customers and creditors upon the federal regulatory scheme, it does not follow that they relied directly or indirectly on the net capital rule, which was but one of many aspects of the regulatory scheme. It is much more likely that Weis' other customers and creditors, as well as Claimants, relied upon the federal regulatory scheme to deter or to uncover false broker-dealer financial statements.

The federal securities laws impose stringent civil and criminal penalties on broker-dealers who knowingly make false financial statements. See, *e.g.*, Sections 15(b) and 32(a) of the Exchange Act, 15 U.S.C. §§78*o*(b), 78ff(a).

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* As discussed in Section III below, the final step in this argument—that Claimants should be estopped from rescinding—would not follow even if the argument's "presumed reliance" theory were accepted.

The SEC and the national securities exchanges such as the NYSE are charged with the responsibility of enforcing the antifraud provisions of the securities laws. See, *e.g.*, Sections 6(b) and 21 of the Exchange Act, 15 U.S.C. §§78f(b) and 78u. As part of its effort to assure the integrity of broker-dealer financial statements, the SEC required that they be certified by independent accountants. SEC Rule 17a-5(d), 17 C.F.R. §240.17a-5(d). Claimants and other creditors of Weis relied on the Weis financial statements because they expected Weis to obey the securities laws, because they relied on the independent accountants' certification of the financial statements, and because they relied on the SEC's and NYSE's surveillance of Weis to uncover any material misstatements.

It is doubtful whether most of Weis' customers and creditors even knew of the existence of the net capital rule. To the extent that customers and creditors of Weis relied on the federal regulatory scheme to protect them in case Weis became insolvent, they probably relied on the tangible insurance benefits provided by SIPA (see Section II.C. below) rather than on the esoteric provisions of the net capital rule.

Apparently recognizing the impossibility of showing reliance by customers and creditors of Weis on Claimants' subordination agreements through alleging their direct reliance upon the net capital rule, the Trustee and SIPC attempt to trace reliance through the NYSE. They argue that the NYSE allowed Weis to continue operating because of Weis' apparent compliance with the net capital rule, and that the apparent compliance was made possible by Claimants' subordinated loans. Yet Weis' apparent compliance and actual noncompliance with the net capital rule were not caused by Claimants' subordinated loans, but by Weis' fraudulent alterations of the figures in its financial statements. If Weis had stated its financial condition truthfully, if the independent auditors had detected the gross

misstatements by which Claimants were defrauded, or if the regulatory bodies charged with supervising Weis had uncovered Weis' fraud, Weis would have been required to cease operations before Claimants' loans were ever made.

In short, to link alleged general reliance on enforcement of the federal regulatory scheme with presumed reliance upon specific subordination agreements which Weis used in connection with one aspect of the regulatory scheme asks too much of logic and law. There is no unbroken chain of reliance which leads to the subordinated loans made by Claimants. And there are too many supervening causes—Weis' fraud, the failure of the independent accountants to detect the gross misstatements in the financial statements, and the failure of the SEC and the NYSE to uncover Weis' fraud—to permit such reliance to be presumed. Accordingly, the elaborate argument constructed by the Trustee and SIPC must fail, since they have not established the premises on which it is based and since its conclusion does not follow from those premises.

B. The National Banking Act Cases Are Not Authority for Barring Rescission.

The District Court found an analogy to this case in the bank assessment cases, quoting *Scott* v. *DeWeese*, 181 U.S. 202 (1901), for the proposition that bank shareholders may not avoid the statutory assessment imposed by the National Banking Act by rescinding their stock purchases on the ground of fraud. 425 F.Supp. at 217-18; A419-A422. Such cases, however, provide no support for the Trustee's position that Claimants should be prevented from rescinding since those cases are founded on language contained in the National Banking Act which is not duplicated anywhere in the federal securities laws.

The National Banking Act provided that the stockholders of a national banking association

> shall be held individually responsible . . . for all contracts, debts and engagements of such association, to the extent of the amount of their stock therein, at the par value thereof, in addition to the amount invested in such shares. . . Revised Statutes §5151 (appearing at 12 U.S.C.A. §63; repealed 1959); see Act of December 23, 1913, ch. 6, §23, 38 Stat. 273 (appearing at 12 U.S.C.A. §64; repealed 1959)

Under another section of the banking laws, creditors of the association were given the right to enforce such liability directly. Act of June 30, 1876, ch. 156, §2, 19 Stat. 63 (appearing at 12 U.S.C.A. §65; repealed 1959).

The courts in the National Banking Act cases such as *Scott* v. *DeWeese,* interpreted the clear language of the statute to impose absolute liability on the stockholders of the bank for the amount of the statutory assessment. There is no comparable provision in the securities laws pertaining to liability of subordinated lenders to broker-dealers, and such absolute liability may not be implied.

In *Oppenheimer* v. *Harriman National Bank & Trust Co.,* 301 U.S. 206 (1937), the Supreme Court made distinctions which show the difference between the absolute liability for assessments under the banking acts and the right of a defrauded investor to rescind in the absence of such express statutory language. In that case, the Court pointed out that the plaintiff shareholder of a national banking association had paid his statutory assessment under the banking laws cited above. 301 U.S. at 214-15. Having done so, he could rescind his stock purchase and share in the general estate of the bank. 301 U.S. at 215. The Court specifically rejected the bank receiver's argument that provisions of the banking laws barred rescission, stating:

> The statutes relied on by defendant cannot reasonably be construed to forbid rescission of fraudulent sales

> by national banks of their own stock. In the absence of language unquestionably disclosing that purpose, Congress may not be held to have so intended. 301 U.S. at 211.

The District Court ignored this language in *Oppenheimer* and treated the statutory assessment imposed against the stockholder in that case as somehow analogous to the subordination agreements executed by Claimants in this case. The analogy fails to hold up because the securities laws contain no provision comparable to the assessment provision of the National Banking Act. Indeed, as discussed in Section I.B. above, the express terms of the federal securities laws, as well as the policies underlying such laws, support Claimants' right to rescind the fraudulently induced agreements. It follows *a fortiori* that the securities laws do not contain the express statutory language barring rescission required by *Oppenheimer*, and that, therefore, Claimants may rescind. See also *Cawthorn* v. *Bancokentucky Co.*, 52 F.2d 850, 852 (W.D. Ky. 1931); *Salter* v. *Williams*, 244 F. 126, 129-30 (3d Cir. 1917), *appeal dismissed*, 250 U.S. 653 (1919).

The District Court erred in overriding the specific provisions of the securities laws which allow defrauded securities holders to rescind because of its view of proper public policy. As demonstrated in the Congressional Hearings on the amendment proposed by the Commission on the Bankruptcy Laws of the United States which would explicitly subordinate rescission claims to other claims in bankruptcy (see pp. 17-18, above), there are substantial arguments in favor of and against the proposed amendment. It is the duty of Congress to weigh the various policy arguments and to determine whether the proposed amendment, which would significantly alter existing law, should be enacted. Until Congress so acts, the law is as stated in *Oppenheimer* and in the federal securities acts—defrauded investors may rescind their investments and

share in the bankrupt's estate on a parity with other creditors.

The subsequent history of the shareholder assessment provisions of the national banking laws is also instructive in this case, revealing the strategy of Congress in dealing with insolvency of institutions which do business with the public. The shareholder assessment provisions were effectively repealed by the Banking Act of 1933, which added 12 U.S.C. §64a to the law.* Instead of requiring innocent purchasers of bank stock to bear the burden of a bank's insolvency, Congress established a system of deposit insurance whereby the Federal Deposit Insurance Corporation ("FDIC") paid claims of depositors up to a certain amount, 12 U.S.C. §1821(f), and the FDIC was then subrogated to the depositors' rights, 12 U.S.C. §1821(g). The insurance fund was maintained by assessments on member banks and backed by the federal government. 12 U.S.C. §§1817, 1821. As discussed immediately below, Congress established a similiar system to deal with broker-dealer insolvencies when it enacted SIPA in 1970.

C. The Securities Investor Protection Act Is Designed To Protect Customers Against Broker-Dealer Insolvencies, But Not By Preventing Subordinated Creditors From Rescinding For Fraud.

The District Court overlooked the means specifically chosen by Congress to accomplish "equity and fairness," 425 F.Supp. at 217; A418, in broker-dealer insolvencies. As described above in the Statement of Facts, SIPA was enacted to protect investors against losses caused by insolvency of their broker-dealer. The industry itself, through SIPC, was to bear the loss. In fact, SIPC has advanced milions of dollars to satisfy customer claims in this case,

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* The provisions were formally repealed in 1959. Act of September 8, 1959, Pub. L. 86-230, §7, 73 Stat. 457.

and it would be the primary beneficiary if the District Court's decision were affirmed.

SIPA's provision that SIPC is subrogated to the claims of the customers for whom it makes advances in no way requires that Claimants be estopped from rescinding. As Claimants show in this brief, customers have no legal basis for asserting an estoppel against Claimants, and certainly "equity and fairness" do not require adoption of a new rule of estoppel for the special benefit of SIPC.

By enacting SIPA, Congress chose a particular method for achieving its goal of protecting the customers of broker-dealers: the creation of a system of industry self-insurance to protect customers against the first $50,000 of losses occasioned by broker-dealer insolvency. It is equally important for purposes of this litigation to note what Congress chose *not* to do when enacting SIPA. Not wanting to supersede all prior law regarding broker-dealer insolvencies, Congress specifically provided that the provisions of the Exchange Act and, with certain exceptions not pertinent here, the general provisions of the bankruptcy laws would apply in SIPA liquidations. 15 U.S.C. §§78bbb, 78 fff(c). No provision of SIPA gives customer claims priority over the claims of other creditors with respect to the assets contained in the general estate of the bankrupt broker, nor is there any language in SIPA which abrogates the right of Claimants under the federal securities and bankruptcy laws to rescind their subordination agreements. One court recently noted that "the fact that Congress has given special protection to public customers through the 'insurance' feature of SIPA does not suggest that it intended to leave [other persons] . . . without a remedy under other provisions of the [Exchange] Act." *New York Stock Exchange, Inc.* v. *Sloan,* 394 F. Supp. 1303, 1313 (S.D.N.Y. 1975).

Prior to the District Court's decision in this case, other courts faced with the question had held that investors de-

frauded by an insolvent broker-dealer in liquidation under SIPA could prove their fraud claims and recover from the broker-dealer's general estate. In *SEC* v. *S.J. Salmon & Co., Inc.*, 375 F. Supp. 867, 870-71 (S.D.N.Y. 1974), a claimant sought to rescind a stock purchase transaction which he claimed was fraudulently induced by the bankrupt broker in violation of Section 10(b) of the Exchange Act. The court held that this fraud claim for rescission was not a "customer claim" within the meaning of SIPA, and therefore that the claim could not be paid out of the special fund maintained by SIPC for the satisfaction of customer claims. The court also stated, however, that the claimant could pursue his fraud claim as a general creditor and look to the broker's general estate for satisfaction of his claim. See also *SEC* v. *C.H. Wagner & Co., Inc.*, 373 F. Supp. 1214, 1220 (D. Mass. 1974), another SIPA liquidation case, where the court held that fraud claims were provable as quasi-contractual claims against the debtor's general estate. The same result should be reached here.

III.

Claimants Are Not Estopped From Rescinding.

At least for purposes of these appeals, all parties agree that Claimants were the innocent victims of fraud committed by Weis. Claimants did not participate in, nor did they have any knowledge of, Weis' fraud. Despite these facts, the Trustee argued below that Claimants ought to be estopped from rescinding their subordination agreements as a matter of law because customers and creditors of Weis indirectly relied on such subordination agreements through the enforcement of the net capital rule. The argument based upon the net capital rule should be rejected for the reasons stated in Section II above. Moreover, insofar as the Trustee's argument implies that Claimants are estopped from rescinding because they signed subordination agreements, he is clearly wrong. A party may not be

estopped by his prior agreement from asserting rights under the securities laws. In addition, the Trustee's argument ignores two fundamental principles of the law of estoppel —that estoppel may not be asserted against one who acted without full knowledge of the facts, and that estoppel may not be applied unless those who would benefit from the estoppel can prove actual detrimental reliance.

A. Claimants Cannot Be Bound by Contractual Terms Purporting To Estop Them From Rescinding.

As discussed above in Section I.B. of this brief, Claimants were entitled to rescind their subordination agreements with Weis because of Weis' violations of the federal securities laws. Indeed, the federal policy in favor of providing a right to relief to defrauded investors under the securities laws is so important that the waiver of such right in advance is statutorily barred. Section 14 of the Securities Act, 15 U.S.C. §77n; Section 29(a) of the Exchange Act, 15 U.S.C. §78cc(a). Numerous cases hold that rights protected by the federal securities laws may not be waived in advance. *E.g., Wilko* v. *Swan*, 346 U.S. 427 (1953); *Schine* v. *Schine*, 254 F.Supp. 986, 988 (S.D. N.Y. 1966), *appeal dismissed*, 367 F.2d 685 (2d Cir. 1967); *Special Transportation Services, Inc.* v. *Balto*, 325 F.Supp. 1185 (D. Minn. 1971); *Stonehill* v. *Security National Bank*, 68 F.R.D 24, 34 (S.D.N.Y. 1975).

In its opinion holding that Claimants were estopped from rescinding, the District Court emphasized the fact that Claimants by executing the subordination agreements had agreed not to participate in any distribution of Weis' assets until the claims of all general creditors of Weis were satisfied. 425 F.Supp. at 215; A410. Insofar as the District Court was suggesting that Claimants lost their right to rescind fraudulently induced subordination agreements because of the terms of those agreements, that suggestion is clearly wrong. Just as parties may not waive in advance their right to relief under the securities laws, they will not

be bound by terms of a contract purporting to estop them from asserting that right:

> Defendants' argument that the terms of the contract it created a binding estoppel is also untenable. Defendants are not allowed to violate the Securities Acts under the guise of contractual provisions. *Andrews* v. *Blue,* 489 F.2d 367, 375 (10th Cir. 1973).

If the subordination agreements executed by Claimants had contained a provision purporting to bar them in case of Weis' insolvency from rescinding the agreements, even though procured by fraud, such provision would clearly be void under Section 14 of the Securities Act and Section 29(a) of the Exchange Act. Yet the Trustee and SIPC attempt to reach the very same result through the indirect means of asserting an estoppel. Their attempt must fail since the affirmative defense of estoppel, like waiver, is strongly disfavored in securities law cases, *Fox* v. *Kane-Miller Corp.,* 398 F.Supp. 609, 624 (D. Md. 1975), and since the remedial aspects of the securities laws cannot be waived either directly or indirectly. *Can-Am Petroleum Co.* v. *Beck,* 331 F.2d 371, 373 (10th Cir. 1964).

B. Claimants Cannot Be Estopped From Rescinding Since They Did Not Participate In, Nor Have Knowledge Of, Weis' Fraud.

The requirements of estoppel are set out in *Hampton* v. *Paramount Pictures Corp.,* 279 F.2d 100, 104 (9th Cir.), *cert. denied,* 364 U.S. 882 (1960):

> Four elements must be present to establish the defense of estoppel: (1) the party to be estopped must know the facts; (2) he must intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe that it is so intended; (3) the latter must be ignorant of the true facts; and (4) he must rely on the former's conduct to his injury.

In this case the very first element of estoppel is not present since Claimants did not know the true facts concerning Weis' financial condition. "There can be no irrevocable estoppel when the truth has been withheld." *Buffum* v. *Peter Barceloux Co.*, 289 U.S. 227, 235 (1933).

The case of *Hurd* v. *Kelly*, 78 N.Y. 588 (1879), is quoted at length in the District Court's decision on appeal to support estoppel of Claimants. However, *Hurd* v. *Kelly* is clearly distinguishable from this case. In *Hurd* v. *Kelly*, the party against whom estoppel was invoked was an active participant in the scheme to defraud. He provided a promissory note to the bank without consideration for the purpose of creating a false picture of the bank's assets in order to deceive the bank examiners. When sued on the note, he attempted to invoke a defense of no consideration. The court held, on far different facts than exist here, that he was estopped from asserting that defense.

The legal result is quite different when the party sought to be estopped does not participate in and has no knowledge of any fraud. Thus, a bank receiver could not recover on behalf of creditors of an insolvent bank from the makers of accommodation notes which may have been used to deceive the bank examiner where the makers did not participate in or know of the deceit. *Andresen* v. *Kaercher*, 38 F.2d 462 (8th Cir. 1930). See also *Rankin* v. *City National Bank*, 208 U.S. 541, 545-46 (1908).

It is especially inappropriate to invoke the equitable doctrine of estoppel against one who is the innocent victim of someone else's fraud. "Generally speaking, an act or representation . . . induced by fraud is not a ground for estoppel." 28 Am. Jur. 2d, Estoppel and Waiver, §45 at p. 654; *McCaskill* v. *Connecticut Savings Bank*, 22 A. 568, 570 (Conn. 1891). In *Deitrick* v. *Standard Surety and Casualty Co.*, 303 U.S. 471, 480 (1938), the receiver of an insolvent national bank attempted to enforce the surety company's guarantees of certain bonds. In its defense, the

surety company showed that it had been fraudulently induced to guarantee those bonds by the bank's president. Under these circumstances, the Supreme Court refused to estop the surety company from repudiating its guarantees.

The principles of estoppel discussed above are equally applicable to attempts to estop a party from rescinding a securities transaction based on a claim of securities law fraud. Such claims may not be estopped unless all of the usual elements of estoppel, including knowledge of the facts by the party to be estopped, are present. In *Andrews* v. *Blue,* 489 F.2d 367, 375 (10th Cir. 1973), the court held that:

> To have an effective estoppel or waiver there must be full knowledge on the part of the [party against whom the estoppel is asserted]. Where, as here, the crucial information was withheld or concealed, the crucial element is not present.

See also *Fey* v. *Walston & Co., Inc.,* 493 F.2d 1036, 1050 (7th Cir. 1974); *Royal Air Properties, Inc.* v. *Smith,* 333 F.2d 568 (9th Cir. 1964); *Collins* v. *Rukin,* 342 F.Supp. 1282, 1291 (D. Mass. 1972).

Since Claimants did not have knowledge of Weis' fraud or of Weis' true financial condition, it follows from the holdings of the cases cited above that they may not be estopped from rescinding subordination agreements procured by such fraud.

C. Claimants Cannot Be Estopped From Rescinding In the Absence of Proof that Other Investors and Creditors of Weis In Fact Relied On Claimants' Subordination Agreements.

The District Court held that Claimants could be estopped from rescinding because of the net capital rule, and, apparently in the alternative, that customers and other creditors of Weis need not prove actual reliance on Claimants' subordination agreements:

> Under the circumstances, actual reliance is not required to be shown. If the reliance doctrine must be satisfied as a point of dogma, it should be presumed as a matter of law. 425 F.Supp. at 217; A419.

This holding is erroneous since actual reliance is a necessary element of estoppel. *Fey* v. *Walston & Co., Inc.*, 493 F.2d 1036, 1050 (7th Cir. 1974); *Royal Air Properties, Inc.* v. *Smith*, 333 F.2d 568, 570 (9th Cir. 1964). There is neither authority nor justification for the District Court's statement that reliance may be presumed as a matter of law.

In this Circuit, the applicable law was stated in *In re Credit Industrial Corp.* ("CIC"), 366 F.2d 402 (2d Cir. 1966). This court there held that the dismissal before trial of defenses asserted by subordinated lenders against CIC's trustee on grounds of common law fraud and federal securities acts violations was error and required a remand to "await such disposition as the law and facts require after the relevant facts have been developed." 366 F.2d at 412.

In *CIC*, subordinated lenders, seeking to set aside their agreements on grounds of common law fraud and violations of the federal securities laws, prevailed in the district court, 250 F.Supp. 582 (S.D.N.Y. 1965), on the theory that a senior creditor has priority over a contractually subordinated creditor only where the senior creditor actually relied on the existence of the subordination agreement in advancing credit. This court reversed, holding that parties may bind themselves to a valid subordination agreement which is enforceable in bankruptcy without regard to proof of reliance. Central to this holding, however, was the premise that there was no infirmity in the subordination agreement. Thus, the court explicitly and repeatedly couched its ruling in terms of the validity of the subordination agreement:

> [T]he enforcement of *lawful* subordination agreements by bankruptcy courts does not offend the policy of

> equal distribution of the bankrupt's estate . . . . 366 F.2d at 408. (Emphasis added.)
>
> • • •
>
> [T]he doctrine of equitable estoppel is clearly irrelevant to a determination of whether a *lawful* subordination agreement is enforceable in bankruptcy proceedings . . . 366 F.2d at 409. (Emphasis added.)
>
> • • •
>
> [A] bankruptcy court, in order to effectuate its duty to do equity, must enforce *lawful* subordination agreements according to their terms . . . 366 F.2d at 410. (Emphasis added.)
>
> • • •
>
> To conclude, we hold that a senior creditor can enforce in bankruptcy a subordination agreement which was executed for his benefit without alleging or proving that he advanced funds in reliance thereon provided that . . . *the agreement is otherwise lawful*. . . . *Id.* (Emphasis added.)

What followed from this reasoning was the court's further holding that affirmative defenses based on common law fraud and violations of the securities acts "may become important to the rights of junior creditors and the noteholders" and would have to await factual development, where it may be shown that the subordination agreements, *themselves unlawful,* make individual proof of creditor reliance a matter which equity may require:

> Reliance may become a relevant factor where equitable considerations require its consideration, namely, where the subordination agreement itself is invalid. See In re Joe Newcomer Fin. Co., 266 F.Supp. 387, 390-392 (D. Colo. 1964); In re Nat'l Discount Corp., 212 F. Supp. 929 (W.D. S.C. 1963). When a junior creditor establishes that the subordination agreement is unlawful, it may be reasonable and necessary, if equity

> is to be done, to require a senior creditor to prove that he relied on the subordination agreement, without actual or constructive knowledge of any infirmity in the agreement, in advancing funds to the bankrupt as a condition to receiving priority in the distribution of the bankrupt's estate. *In cases where the underlying subordination agreement is unlawful, a court is not confronted with the problem of enforcing express contractual provisions but, rather, with the entirely separate problem of determining which general creditors should bear a loss caused by the debtor, a problem which may have to be resolved by reference to equitable principles.* 366 F.2d at 409. (Emphasis added.)

This Court's analysis in *CIC* was explicitly grounded upon the well-settled principles of contract law which provide that a third party beneficiary's (senior creditor's) rights in a suit against the promisor (subordinated lender) are derivative and entirely dependent upon the validity of the agreement which gave rise to them. 366 F.2d at 411, n. 6. *See Rouse* v. *United States,* 215 F.2d 872, 874 (D.C. Cir. 1954). 4 *Corbin on Contracts* § 818, at 266-67 (1951); 2 *Williston on Contracts* § 394, at 1063-64 (3d ed. 1959). In the case at bar, since it is conceded for purposes of these appeals that the subordination agreements between Claimants and Weis are subject to the equitable defense of fraud, Claimants have a right to assert this defense *and offer their proofs* against claims filed by senior creditors as alleged third party beneficiaries of the subordination agreements. Thus, in *CIC,* the court held that the district court erred in granting the Trustee's motion to strike certain defenses because the effect of those defenses on the rights and priorities of senior creditors would have to await "an appropriate resolution thereof upon the law and facts as developed." 366 F.2d at 412.

This holding cannot be dismissed, as the District Court did here, as "dicta" under even the most miserly reading

of the decision. The District Court attempted to distinguish *CIC* from the case at bar by stressing the fact that Weis, unlike the insolvent corporation in *CIC*, was a broker-dealer regulated by the federal securities laws. Yet, as discussed above in Section II, no provision of the federal securities laws, including the net capital rule, imposes absolute liability on subordinated creditors of broker-dealers or prevents subordinated creditors from rescinding subordination agreements which were procured by fraud. Therefore, the District Court's factual distinctions do not change the holding stated in *CIC* that the fraud claims of subordinated lenders may not be summarily dismissed unless the senior creditors can prove that they relied on the subordination agreements.

CIC is not the only case which holds that proof of reliance is necessary to estop subordinated lenders from rescinding. In *Aixala* v. *W. E. Hutton & Co.* [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,981 (S.D. N.Y. 1975), and in *In re Joe Newcomer Finance Co.*, 226 F.Supp. 387 (D. Colo. 1964), the courts upheld the rescission or reformation of fraudulently induced subordination agreements in the absence of proof that third party creditors relied on such agreements.

The District Court gave unmerited and excessive attention to the Trustee's problems of proof of reliance and to the Bankruptcy Court's discussion of procedures to be followed for trial of the facts.* It is a serious distortion of legal priorities to consider difficulties of proof of facts needed to establish an affirmative defense as a factor

* The procedures outlined by the Bankruptcy Court are eminently logical as well as precisely in accord with common law requirements for proof of estoppel. See 2 *Williston on Contracts* §397 (3d ed. 1959). Nevertheless, these appeals do not present for review the procedures to be followed in trying the facts. If the District Court found the procedure outlined by the Bankruptcy Court to be improper, its appropriate action would be to remand to the Bankruptcy Court with instructions to follow a different procedure, not to reverse outright.

which supports dispensing with the need for proof of the defense. In the facts of this case, Claimants have the undoubted right to rescind unless the Trustee can establish his estoppel defense. Claimants' fundamental rights should be sustained, not taken away, if the necessary elements of the defense cannot be proved.

Furthermore, proof of the facts constituting the Trustee's defense would be difficult, not because of the number of customers and creditors of Weis involved, but because such customers and creditors of Weis did not, in fact, rely on the subordination agreements of Claimants. Most investors and creditors of broker-dealers are unaware of the existence of the net capital rule. Fewer still would know that subordinated debt is treated as capital under that rule, and virtually none would have relied on the specific subordination agreements executed by Claimants. It is more likely that customers and creditors of Weis relied on the certified Weis financial statements, on the NYSE's and the SEC's surveillance of Weis, and on the insurance protection provided by the SIPA.

IV.

Summary Judgment Is Improper In This Case Because Genuine Issues of Material Fact Exist.

As the Bankruptcy Judge recognized, summary judgment should be granted sparingly:

> [T]rial judges should exercise great care in granting motions for summary judgment. A litigant has a right to a trial where there is the slightest doubt as to the facts, and a denial of that right is reviewable; but refusal to grant a summary judgment is not reviewable. Such a judgment, wisely used, is a praiseworthy time-saving device. But, although prompt dispatch of judicial business is a virtue, it is neither the sole nor the

> primary purpose for which courts have been established. Denial of a trial on disputed facts is worse than delay. The district courts could do well to note that time has often been lost by reversals of summary judgments improperly entered. *Doehler Metal Furniture Co.* v. *United States*, 149 F.2d 130, 135 (2d Cir. 1945). (Citations omitted.)

Accord, *Heyman* v. *Commerce and Industry Insurance Co.*, 524 F.2d 1317, 1320 (2d Cir. 1975).

There are genuine issues of fraud, intent, reliance and culpability in this case which cannot be determined without a trial. The District Court presumed unproven and disputed facts concerning the knowledge and intent of the Claimants in entering into the subordination agreements, the matters upon which Weis customers and creditors relied, the difficulty of proving reliance, and the need for enforcement of fraudulently induced subordination agreements in order to accomplish "equity and fairness." All of these questions require trial.

The impropriety of summary judgment is magnified by the reliance of the District Court upon its interpretation of significant issues of public policy. The Supreme Court has warned against the use of summary procedures in such situations:

> But summary procedures, however salutary where issues are clear-cut and simple, present a treacherous record for deciding issues of far-flung import, on which this Court should draw inferences with caution from complicated courses of legislation, contracting and practice.
>
> We consider it the part of good judicial administration to withhold decision of the ultimate questions involved in this case until this or another record shall present a more solid basis of findings based on litigation or on a comprehensive statement of agreed facts.

> While we might be able, on the present record, to reach a conclusion that would decide the case, it might well be found later to be lacking in the thoroughness that should precede judgment of this importance and which it is the purpose of the judicial process to provide. *Kennedy* v. *Silas Mason Co.*, 334 U.S. 249, 256-57 (1948). (Footnote omitted.)

Important questions of public policy such as whether the decision below will best assure the financial responsibility of broker-dealers, or, instead, will discourage institutions and individuals from making subordinated loans to broker-dealers, and whether the right of defrauded investors to rescind should be subordinated to the financial interests of SIPC and other creditors of an insolvent broker-dealer should not be decided without a full hearing.

CONCLUSION

The order of the District Court should be reversed, and this case should be remanded to the Bankruptcy Court for further proceedings consistent with its opinion of July 15, 1976.

May 9, 1977.

Respectfully submitted,

LAWRENCE BLOCK
THOMAS P. LUNING
CARL A. ROYAL
SCHIFF HARDIN & WAITE
7200 Sears Tower
233 South Wacker Drive
Chicago, Illinois 60606

and

ALAN C. WINICK
500 Fifth Avenue
New York, New York 10036
Attorneys for All American Life & Casualty Co., General United Life Insurance Co. and Robert Slater

SIDNEY DICKSTEIN
DICKSTEIN, SHAPIRO & MORIN
2101 L Street, N.W.
Washington, D.C. 20037
Attorneys for George Aldrich, H. Wallace Cohu, John DeBraganca, James J. Higginson, Grace Cutting McGrath, Grace M. McGrath, Craig K. Mitchell, Eugene W. Stetson, Jr., Jean M. Winslow, Samuel Winslow, Estate of Philip H. Holden, Deceased.

WILLIAM J. SCOTT
Attorney General of Illinois
160 North LaSalle Street
Chicago, Illinois 60601

and

MILLER, SINGER, MICHAELSON,
BRICKFIELD & RAINES
555 Madison Avenue
New York, New York 10017
Attorneys for Eva Grossman

ZALKIN, RODIN & GOODMAN
750 Third Avenue
New York, New York 10017
Attorneys for Chemical Bank

BAER & MARKS
70 Pine Street
New York, New York 10005
Attorneys for Fidelity Corporation

STACKPOLE & AMIDON
P.O. Box 1016
Stowe, Vermont 05672
Attorneys for Arthur J. Kriezel

CERTIFICATE OF SERVICE

I, ALAN C. WINICK, as counsel for Claimants-Appellants, ALL AMERICAN LIFE & CASUALTY CO., GENERAL UNITED LIFE INSURANCE CO. AND ROBERT E. SLATER, and as lead counsel for all Claimants-Appellants pursuant to the Civil Appeal Pre-Argument Conference Order, dated March 16, 1977, hereby certify that on the 10th day of May, 1977, I served two copies of the Joint Brief of Claimants-Appellants upon the following persons by depositing said copies in the United States Mails(Federal Express, Inc.), properly paid and addressed to them as indicated below:

Theodore H. Focht
Wilfred R. Caron
Michael E. Don
Securities Investor Protection Corporation
900 Seventeenth Street, N.W.
Suite 800
Washington, D.C. 20006

Attorneys for Securities Investor Protection Corporation

Dated: New York, New York
May 10, 1977

ALAN C. WINICK

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss .

Frantz Fontaine, being duly sworn, deposes and says that deponent is not a party to the action, is over 18 years of age and resides at 193 Kane St B'klyn New York 11231.

That on the 10th day of MAY, 1977, deponent personally served the within JOINT BRIEF FOR APPELLANTS upon the attorneys designated below who represent the indicated parties in this action and at the addresses below stated which are those that have been designated by said attorneys for that purpose.

By leaving 2 true copies of same with a duly authorized person at their designated office.

~~By depositing _____ true copies of same enclosed in a postpaid properly addressed wrapper, in the post office or official depository under the exclusive care and custody of the United States post office department within the State of New York.~~

Names of attorneys served, together with the names of the clients represented and the attorneys' designated addresses

JAMES W. GIDDENS
JAMES B. KOBAK, JR.
HUGHES, HUBBARD & REED
Attorneys for Appellee Edward S. Redington, as Trustee
One Wall Street
New York, N. Y. 10005

Frantz Fontaine

Sworn to before me this

10th day of MAY, 1977.

Michael DeSantis

MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Queens County
Commission Expires March 30, 1979

Counsel Press, 55 West 42nd Street, PE 6-8460